No. 12391

In the United States Court of Appeals for the Ninth Circuit

Agnes M. Kanne, Executrix Under the Will and of the Estate of Fred H. Kanne, Collector of Internal Revenue of the United States for the District of Hawaii, appellant

v.

American Factors, Limited, an Hawaiian Corporation, appellee

American Factors, Limited, an Hawaiian Corporation, appellant

v.

Agnes M. Kanne, Executrix Under the Will and of the Estate of Fred H. Kanne, Collector of Internal Revenue of the United States for the District of Hawaii, appellee

ON APPEALS FROM THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF HAWAII

BRIEF FOR AGNES M. KANNE

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No. 12391

AGNES M. KANNE, EXECUTRIX UNDER THE WILL AND OF THE ESTATE OF FRED H. KANNE, COLLECTOR OF INTERNAL REVENUE OF THE UNITED STATES FOR THE DISTRICT OF HAWAII, APPELLANT

v.

AMERICAN FACTORS, LIMITED, AN HAWAIIAN CORPORATION, APPELLEE

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BRIEF FOR AGNES M. KANNE

OPINION BELOW

The opinion of the District Court (R. 59-66) is reported in 76 F. Supp. 133.

JURISDICTION

This appeal involves federal income tax for the year 1932. The tax in dispute was paid as follows: $62,438.82 on December 30, 1937, and $12,657.68 on October 26, 1938. (R. 14-16.) A claim for refund covering the tax paid December 30, 1937, was filed on April 5, 1938, and rejected by notice dated December 2, 1938. (R. 15.) By letter dated June 29, 1938, the Commissioner of Internal Revenue determined an additional deficiency in tax of $12,657.68 which was paid as stated above on October 26, 1938, and on December 22, 1938, a second claim for refund of the additional tax and interest collected thereon was filed, but no action was taken on this second refund claim and more than six months had elapsed since the filing of this claim when this suit was instituted. (R. 15-16.)

Within the time provided in Section 3772 of the Internal Revenue Code and on January 6, 1940, the taxpayer brought an action in the District Court for the Territory of Hawaii for recovery of the taxes paid. (R. 2-17.) Jurisdiction was conferred on the District Court by the Act of April 30, 1900, c. 339, 31 Stat. 141, Section 86, as amended. Judgment was entered on June 15, 1949. (R. 104-106.) Within sixty days and on August 4, 1949, a notice of appeal was filed by the Collector,[1] and on August 15, 1949, the taxpayer filed a notice of appeal. (R. 107-109.) Jurisdiction is conferred on this Court by 28 U. S. C., Section 1291.

QUESTIONS PRESENTED

Raised by Collector's appeal:

1. Whether certain litigation expenses in the amount of $83,802.76, which were paid by taxpayer in years

[1] The Collector herein now dead, his executrix, Agnes M. Kanne, was substituted as defendant in the court below. Throughout this brief we are using the term Collector for convenience and brevity.

prior to 1932, accrued prior to 1932 with the consequence that the expenses may not be deducted in 1932 by taxpayer, which reports on the accrual basis of accounting.

2. Whether litigation expenses in the amount of $87,-992.50, paid in 1932, accrued prior to that year, with the result that they are not properly deductible in 1932 by the taxpayer on the accrual basis of accounting.

Raised by taxpayer's appeal:

3. Whether taxpayer was legally obligated to reimburse certain of its stockholders for litigation expenses of $396,812.50 contributed by the stockholders in defending a suit in which taxpayer and they were codefendants, with the consequence that taxpayer may deduct in 1932 the distribution of $396,812.50 to such stockholders in that year.

4. Whether a payment of $50,000 in 1931 to a trust company for the purpose of preventing its financial collapse was merely a contribution rather than creating an indebtedness of a kind which may be deducted in 1932 under Section 23 (j) of the Revenue Act of 1932 as a bad debt ascertained to be worthless and charged off.

5. Alternatively, whether the $50,000 payment may be deducted as an ordinary and necessary business expense in 1932 under Section 23 (a) of the Revenue Act of 1932 or as a loss sustained in 1932 under Section 23 (f) of the Act.

STATUTES AND REGULATIONS INVOLVED

The applicable statutes and Regulations are printed in the Appendix, *infra.*

STATEMENT

This case comes to this Court on cross appeals from a judgment partially in favor of the taxpayer in an

action below to recover income tax in the amount of \$97,134.90, with interest for the calendar year 1932.

The material facts as found by the District Court (R. 67-100), may be summarized as follows:

Facts relating to litigation expenses.

The controlling capital stock of H. Hackfeld & Company (hereinafter referred to as "Hackfeld"), a Hawaiian corporation engaged principally in the sugar agency and factor business, was owned by German interests. In March, 1918, this stock was seized by the United States Alien Property Custodian. A plan of reorganization was formed, as a result of which the taxpayer, American Factors, Limited, was organized to take over the business and assets of Hackfeld. The stock (trust certificates) of taxpayer under the plan was to be sold to American citizens engaged in or familiar with the sugar agency business in Hawaii. Pursuant to the plan trust certificates representing 50,000 shares of taxpayer's stock were sold for a total price of \$7,500,000, which was paid to Hackfeld in exchange for all its assets and business. Persons who were the incorporators of taxpayer and who subsequently became its officers and directors entered into a joint subscription agreement under which they became the owners of trust certificates for 25,000 shares of taxpayer's stock. (R. 68-70.)

In June, 1924, taxpayer's directors were informed that former stockholders of Hackfeld, then dissolved, were threatening litigation, but it was not known who would be named defendants. Taxpayer's directors authorized employment of counsel to defend it, if it were named as a defendant. On July 28, 1924, 21 of the 23 persons and corporations, who had joined in the joint subscription agreement, agreed in writing to prorate on an original per share basis the expenses of

the threatened litigation, if they were joined as defendants. (R. 70-71.)

In August and September, 1924, identical suits were filed by J. C. Isenburg and others in a Hawaii and a California state court against the Alien Property Custodian, the taxpayer and the 23 persons and corporations who were parties to the joint subscription agreement, as codefendants. Only the California suit was tried. The complaint in that suit alleged *inter alia* that the sale of Hackfeld's assets to taxpayer was fraudulent and at a price far below the true value of the assets, and that the taxpayer had improperly managed Hackfeld's business. It claimed damages in the total amount of $12,500,000 from all defendants, except the Alien Property Custodian, to be fixed in such manner as the court deemed proper. The attorneys employed by the taxpayer prepared and filed a joint answer on behalf of the taxpayer and the codefendants other than the Alien Property Custodian. (R. 71-74.)

On January 6, 1926, the California court filed a memorandum and on March 16, 1926, a decision, in both of which it found that there was no fraud and that the price paid for the Hackfeld assets was adequate. On January 31, 1927, it entered judgment for the defendants. On April 30, 1931, the Supreme Court of California affirmed the judgment of the trial court and thereafter denied a petition for rehearing and a motion of the plaintiffs. On April 25, 1932, the United States Supreme Court denied certiorari. This terminated the litigation. (R. 75-77.)

The total cost of the Hackfeld litigation was $568,607.76 which the taxpayer paid.[2] From time to time (prior to 1932) the taxpayer received from its codefendants their pro rata share of the total expenses

[2] All of the expenses were paid in years prior to 1932 except for $87,992.50 paid in 1932. (R. 198.)

paid in the amount of $396,812.50. In 1932 after the conclusion of the litigation taxpayer repaid to its codefendants the $396,812.50 advanced by them during the progress of the litigation. Repayment was authorized by taxpayer's directors but was wholly voluntary, was not pursuant to demand of the codefendants, and was not a result of a test of the right of the codefendant stockholders to have contributions at the expense of other shareholders not named as defendants in the litigation. There is no evidence that taxpayer promised or intended to reimburse the codefendants at the time they subscribed or contributed to the litigation expense, or that taxpayer considered the matter until the litigation was concluded in 1932. The approval by taxpayer's stockholders of the reimbursement of the codefendants from the taxpayer's funds apparently flowed largely from gratitude for the successful outcome of the litigation and for the liberal aid of the codefendants in supplying facilities and influences which could not have been supplied by taxpayer alone. (R. 77-78.)

The Hackfeld litigation imperiled taxpayer's existence. Taxpayer had substantial interests to protect and much to lose if the codefendants had not volunteered to fight the battle at their own cost and if taxpayer had not accepted their payment plan and their volunteered services. (R. 79.)

In making the agreement to pay voluntarily their shares of the expenses for defending the litigation, the codefendants were motivated entirely by keen personal desires to clear themselves of charges of unlawful conspiracy and fraud, to escape a judgment against them for damages, and to protect their individual investments as shareholders. They offered to pay, and did pay to the extent of assessments against them, their contributions to the litigation defense fund with-

out promise or expectation of reimbursement. (R. 78-79.)

During the years 1924-1932, inclusive, taxpayer's books were kept, and its tax returns were filed, on the accrual basis of accounting. Over that period it carried the payments totaling $568,607.76 as deferred items on its records until after conclusion of the litigation in 1932. At that time it charged off on its books the entire amount [3] and took a deduction for the entire amount in computing its net taxable income on its income tax return for 1932. (R. 77, 79, 96.) The Commissioner of Internal Revenue disallowed the entire amount as a deduction. (R. 79.)

The District Court concluded that taxpayer was entitled to deduct in 1932 as an ordinary and necessary business expense under Section 23 (a), Revenue Act of 1932, the amount of $171,795.26, representing the Hackfeld litigation expenses paid by it. (R. 100-101.) The Collector has appealed.

The District Court further concluded that taxpayer was not legally obliged or liable to repay the amount of $396,812.50 to its codefendants in the Hackfeld litigation, and that taxpayer is not entitled to deduct the amount in 1932 as an ordinary and necessary business expense under Section 23 (a). (R. 101-102.) The taxpayer has appealed.

Facts relating to $50,000 payment claimed as bad debt or loss.

The Henry Waterhouse Trust Company, Limited (hereinafter referred to as "Waterhouse") was a

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[3] In 1932, $541,237.79 of these expenses was charged to the taxpayer's general reserve account which was carried over from H. Hackfeld & Company, Limited, and the balance of $27,369.97 of these litigation expenses was charged against the taxpayer's earned surplus. (R. 289.) No part of these litigation expenses was charged to profit and loss on the taxpayer's books. (R. 295.)

Hawaiian corporation engaged in the trust company business. In 1930 a large part of its assets consisted of real estate and mortgages and its secretary became apprehensive that if many calls were made on its demand accounts, due to the effect of the business depression, its condition was not sufficiently liquid to meet its cash requirements. In 1931 it was conducting business as usual, but was encountering some financial difficulties. The Bishop Trust Company (hereinafter referred to as "Bishop"), which had been considering the purchase of Waterhouse's stock for cash, after investigation, advised in 1931 that it would not pay cash for the shares. A. W. T. Bottomley, president of taxpayer and of a Honolulu bank and vice-president of Bishop, then called a conference of the heads of the principal Hawaiian sugar agencies and banks to present the financial condition of Waterhouse and to discuss plans to prevent Waterhouse's forced litigation. (R. 79-81.)

On February 14, 1931, at a meeting of the directors of Bishop, a plan was presented, largely as a salvage proposition, pursuant to which Bishop would acquire all of Waterhouse's stock without cost and would operate its business for Bishop's own benefit. Cash payments totaling $1,035,000 were to be made to Waterhouse by Bishop, creditors and others. Included in this total figure was a cash contribution of $400,000 to be made by a number of corporations and individuals. Waterhouse's assets and liabilities were to be retained by it and were to be liquidated gradually under Bishop's supervision for a fee of $1,000 per month. Upon final settlement, if any proceeds remained after paying liabilities and expenses, repayment was to be made first to Bishop for any advances made by it in excess of the $1,035,000 cash, and then pro rata to the contributors of the $400,000, together with four percent

interest. The objects of the plan were to prevent Waterhouse's failure with its general disastrous effects, to prevent loss on the part of the depositors who could ill afford to lose, and to enable Bishop to acquire new business. The plan as outlined was approved by Bishop's board of directors and the cash payments mentioned were duly made a few days after February 14, 1931. (R. 81-84.)

Prior to that date certain corporations, including taxpayer, and individuals had promised to pay to Waterhouse upon consummation of the proposed plan the total amount of $400,000. Taxpayer's contribution was $50,000. The total amount was actually paid to Waterhouse by the corporations, including taxpayer, and individuals as promised by them. For these contributions Waterhouse's notes, bearing interest at four percent, were given, subject to being paid however only after other liabilities and expenses of Waterhouse were paid, as provided in the plan and as outlined by Waterhouse in letters to the contributors. (R. 84-90.) The note for $50,000 issued to taxpayer by Waterhouse was dated February 21, 1931, and contained the provision that (R. 90):

> * * * payment of principal and interest to be made only when, if and to the extent that there shall be funds available therefor as set forth in letter of this date from the payor to the payee.

Taxpayer was not a stockholder of Waterhouse. (R. 90.)

An audit report dated March 31, 1931, listed the book value of Waterhouse's assets as of February 14, 1931, as $4,820,090.92 and the book value of its liabilities, exclusive of capital and surplus, on that date as $4,149,-437.02. The audit report stated that the reserve for losses of $680,803.15 and the special contingent reserve

of $400,000 (for "underwriters" (R. 95)) were considered adequate to cover probable losses in the realization of assets and liquidation of liabilities. At December 31, 1931, Waterhouse had actually sustained on liquidation a loss of $324,913.77 and at December 31, 1932, a cumulative loss of $410,345.80, so that at the end of 1932 there remained a balance of $190,457.35 in the reserve for losses, against which future losses would be charged before there would be an impairment of the special contingent reserve for repaying the $400,000 contributions to the special noteholders. (R. 91-95.)

The $50,000 note received by taxpayer was contingent as to payment and subject to such conditions as to render it nonnegotiable at that time and thereafter, and without negotiable value at any time. There is no evidence that taxpayer would have suffered any loss if it had not attempted to keep Waterhouse a going concern. The considerations flowing to taxpayer for its contribution of $50,000 were the protection of the commercial community, sympathy toward clients of Waterhouse who could not afford to lose, and other commendable desires and motives of helpfulness and security. (R. 96.)

In 1932 taxpayer charged off on its books as a bad debt the $50,000 note received in 1931. (R. 96-97.)

The District Court concluded that the payment of $50,000 to Waterhouse in 1931 was only a contribution; that the note given to it in acknowledgment of the contribution was not a debt; and that no part of the $50,000 was deductible in 1932 as a bad debt ascertained to be worthless and charged off within the terms of Section 23 (j) of the Revenue Act of 1932. The District Court further held that no part of the $50,000 was deductible as a loss sustained in 1932 under Section 23 (f) of the 1932 Act. (R. 102-103.)

STATEMENT OF POINTS TO BE URGED BY AGNES M. KANNE

The Collector's statement of points on appeal (R. 618-619), all of which are relied on here, may be summarized as the following point:

The District Court erred in holding that the taxpayer is entitled to deduct in 1932 $171,795.26 of the Hackfeld litigation expenses as expenses accruing in that year.

SUMMARY OF ARGUMENT

I. The taxpayer's share of the Hackfeld litigation expenses was $171,795.26, which the District Court held could be deducted by taxpayer in 1932. This holding is erroneous. No part of the amount was incurred or accrued as an expense in 1932, and Section 43 of the Revenue Act of 1932 therefore forbids any deduction in 1932 by the taxpayer which reports on the accrual basis of accounting.

Of the amount, $83,802.76 was paid by taxpayer prior to 1932. The liability to pay and the amount thereof must have been fixed when the expenses were paid, and the expenses therefore necessarily had accrued before being paid. In any case, the proof offered requires this conclusion, for the defense at the trial and on appeal was concluded prior to 1932. There was no showing that the amounts paid prior to 1932 were to cover any services performed or expene to be incurred in 1932.

Taxpayer paid $87,992.50 of its share of the expenses in 1932, but failed to prove, as it was required to do in order to prevail, that any part of these expenses were incurred and accrued in 1932. And the history of the litigation makes it highly doubtful that any of the expenses were incurred in 1932. Taxpayer must fail on this item for lack of proof to establish its accrual and deductibility in 1932.

II. The stockholder-incorporators' share of the Hackfeld litigation expenses was $396,812.50 which they paid in 1924-1926. The taxpayer reimbursed them for these expenses in 1932. The District Court correctly held that the amount was not deductible in 1932.

The amount was not incurred in carrying on the taxpayer's business, as Section 23 (a), Revenue Act of 1932, requires as one condition for a deduction. It was not a part of the taxpayer's sugar agency and factor business to pay expenses of defending its stockholder-incorporators from charges of fraud and conspiracy occurring before taxpayer's organization and before it engaged in business nor was the payment of expenses of protecting its stockholders' property proximately connected with its business.

Furthermore, the expenses were those of taxpayer's stockholder-incorporators and thus were not ordinary, that is, normal or customary, expenses of taxpayer's business as Section 23 (a) requires to permit a deduction. The taxpayer's payment of the expenses was wholly voluntary and not legally required, as the District Court correctly found.

Finally even assuming *arguendo* that the stockholder-incorporators' share of the expenses might be deducted by taxpayer in the year of accrual, 1932 was not the year in which the expenses accrued. The expenses were incurred and paid by the stockholders from 1924 to 1926, inclusive. Assuming *arguendo* that taxpayer had an obligation, as it emphatically contends, to reimburse the stockholders, that liability existed in 1924-1926 and accrued at that time. Taxpayer cites no authority and offers no convincing argument to support its contention that its obligation to reimburse accrued only when the litigation was finally terminated in 1932.

III. The $50,000 contributed to the Waterhouse fund in 1931 is not deductible in 1932 as a bad debt ascertained to be worthless and charged off in that year under Section 23 (j), Revenue Act of 1932. The $50,000 note received by taxpayer from Waterhouse was not payable at all events but its payment was contingent on Waterhouse having funds to pay it after all of its other liabilities and expenses had been paid. Moreover, the $50,000 was paid by taxpayer as a contribution to serve the community generally and without expectation of repayment. Under the authorities, both of these circumstances require the conclusion that no debt sufficient to support a deduction under Section 23 (j) was created.

Furthermore, assuming *arguendo* only that a valid debt was created, the taxpayer failed to prove facts sufficient to enable the District Court to determine that taxpayer's alleged ascertainment of worthlessness of the debt in 1932 was based on facts warranting that conclusion. Moreover, the record strongly indicates that taxpayer did not deem the "debt" worthless in 1932, assuming *arguendo* that it ever believed the note had value, since it declined to concede its worthlessness for other purposes.

The $50,000 paid in 1931 is not deductible as a loss sustained in 1932, because a voluntary contribution is not a basis for deducting a loss at any time. Moreover, the loss, if there was one, was not sustained in 1932 and could not be deducted in 1932 under Section 23 (f). Nor is the $50,000 deductible as an ordinary and necessary business expense in 1932. While the payment is not an ordinary business expense, even if it were so considered, it accrued in 1931 at the time it was incurred and paid and could not be deducted in 1932 under Section 23 (a).

ARGUMENT

I

Taxpayer Is Not Entitled to Deduct in 1932 $171,795.26 Representing the Part of the Hackfeld Litigation Expenses Paid by It

The expenses of the Hackfeld litigation totaled $568,-607.76. Of this amount $396,812.50 was contributed in 1924, 1925, and 1926 by the taxpayer's codefendants in the litigation (R. 198-200) and was paid in years prior to 1932 (R. 198). Of the remaining $171,795.26, which was taxpayer's share of the expenses and was paid by it, $83,802.76 was paid in years prior to 1932, and $87,992.50 was paid in 1932. (R. 198.) The District Court allowed deduction in 1932 of taxpayer's total share of the expenses regardless of when paid, but denied deduction in 1932 of the $396,812.50 returned by taxpayer to its codefendants in that year. The $396,-812.50 item will be shown to have been correctly disallowed in Point II, *infra*. This point will be devoted to the $171,795.26 part of the expenses paid by the taxpayer. It is our position that the District Court erred in allowing deductions for the $87,992.50 paid in 1932 and the $83,802.76 paid prior to 1932, since there is no showing that any of the expenses accrued in 1932 so as to be deductible by taxpayer which reports on the accrual basis of accounting. No contention is made that the litigation expenses paid by the taxpayer were not ordinary and necessary business expenses within the meaning of Section 23 (a) of the Revenue Act of 1932 (Appendix, *infra*). Nevertheless, they are not properly deductible in 1932 under Sections 41 and 43 of the 1932 Act (Appendix, *infra*) since they did not accrue within that year.

Before presenting our argument on the deductibility of the two amounts, some basic principles applicable to all claimed deductions generally are noted. It is settled

that deductions from gross income are not a matter of right but of legislative grace and that the burden is upon the taxpayer claiming a deduction to establish its right thereto, by bringing itself squarely within the terms of the statute authorizing the deduction. *New Colonial Co.* v. *Helvering,* 292 U. S. 435, 440; *White* v. *United States,* 305 U. S. 281, 282; *Helvering* v. *Ind. Life Ins. Co.,* 292 U. S. 371, 381; *Woolford Realty Co.* v. *Rose,* 286 U. S. 319, 326. Moreover, the ruling of the Commissioner of Internal Revenue that the deductions claimed are not allowable is presumed correct and the taxpayer has the burden of proving it to be wrong. *Welch* v. *Helvering,* 290 U. S. 111, 115.

A. *The $83,802.76 paid by taxpayer prior to 1932 cannot be deducted in 1932*

Section 43 of the Revenue Act of 1932 provides that deductions provided for in the income tax title shall be taken for the taxable year in which they were "paid or accrued", dependent upon the method of accounting employed in computing net income. Since the taxpayer kept its books and made its tax returns on the accrual basis of accounting in 1932 and for many years prior thereto (R. 394), it can deduct in 1932 under the statute only the litigation expenses which accrued in 1932.

As shown, the amount of $83,802.76 out of the total $171,795.26, representing taxpayer's share of the litigation expenses, was stipulated to have been paid in years prior to 1932. In fact, $32,513.15 of the amount was paid in 1924; $26,356.62 in 1925-1926; $6,255.49 in 1927; $12.27 in 1928; $13,313.55 in 1929; $832 in 1930; and $4,519.68 in 1931. (R. 198-200.) Since the $83,802.76 had been paid in its entirety prior to 1932, it is not possible to conclude that the amount accrued in 1932. As the Court of Claims said in *Chestnut Securities Co.* v. *United States,* 62 F. Supp. 574, 576, with respect to a

taxpayer which paid an asserted liability for state taxes but immediately commenced an unsuccessful suit for their refund:

> It is hardly conceivable that a liability asserted against him, which he has discharged by payment, has not yet "accrued" within the meaning of the tax laws and the terminology of accounting. Accrual, from the debtor's standpoint, precedes payment, and does not survive it.

In this case, although the District Court permitted deduction of the $83,802.76 in 1932, it made no findings which would support a conclusion that the amount accrued as a liability in 1932. The District Court found that the taxpayer carried the total litigation expenses of $568,607.76 as deferred items on its books until after conclusion of the litigation (R. 77), but it made no finding as to the reason for doing so, and the mere fact that taxpayer carried the expenses as deferred items after they had actually been paid does not warrant a conclusion that the *paid expenses* had not accrued at the time they were paid. An expense accrues for deduction purposes at the time the events occur which determine the liability to pay and fix the amount, even though the amount has not then been ascertained. *United States* v. *Anderson,* 269 U. S. 422, 441; *Brown* v. *Helvering,* 291 U. S. 193, 200. It is certainly not to be inferred that a debtor will pay amounts for which his liability has not become fixed within reasonable limits, and indeed if he did so, the payment might well not be considered as a deductible expense but rather more in the nature of a gift or contribution.

The facts here in any case compel the conclusion that the liability for the payments made prior to 1932 had accrued prior to 1932. The Hackfeld suit was commenced in 1924 and in January of 1927, judgment in favor of taxpayer and its codefendants was entered by

the trial court. Approximately $450,000 of the total expenses of $568,607 was paid in the years 1924-1926, inclusive (R. 198), quite apparently for the preparation of the defense and the trial. The appeal to the Supreme Court of California was concluded in 1931, except for the denial in January, 1932, of the motion to recall the remittitur which had been filed in August, 1931. Obviously the preparation and work in connection with the appeal had been completed in 1931 and the payments of expenses made in the years 1927-1931, inclusive, must be deemed to have accrued in connection with such work, and other items in connection with the litigation up to that point. There is no proof whatever that the pre-1932 payments covered services to be performed in 1932, or expenses to be incurred in 1932.

Since the amount of $83,802.76 was paid by taxpayer prior to 1932 and the taxpayer has failed to show that the amount did not accrue as a liability until 1932, it follows that the District Court erred in allowing the amount as a deduction in 1932.

B. *The $87,992.50 paid by taxpayer in 1932 was not shown to be deductible in 1932*

The Commissioner disallowed deduction of all the litigation expenses ($171,795.26) paid by taxpayer, including the $87,992.50 paid in 1932, for the reason that there was no evidence that any of the services for which payment was made in 1932 had actually been rendered in that year but that the evidence indicated that practically all the legal fees and expenses had been incurred prior to 1932. (R. 577-578, Deft. Ex. B.) As shown above, this determination is presumed correct and the taxpayer had the burden of showing that the expenses actually had been incurred and that they accrued in 1932. It wholly failed to make this showing and in fact

the record strongly indicates that the expenses paid in 1932 actually accrued prior to that time.

As already pointed out, the trial court entered judgment for the defendants in January, 1927, the judgment was affirmed on appeal on April 30, 1931; and petition for rehearing was denied on May 28, 1931. Thereafter on August 26, 1931, a motion to recall the remittitur was filed, which was denied by the Supreme Court of California on January 29, 1932. On April 25, 1932, a petition for certiorari was denied by the Supreme Court. This history of the litigation makes it highly doubtful that any expenses in connection with it were incurred in 1932. Even the expenses, if there were any which the record does not show, in connection with defending against the motion to recall the remittitur must necessarily have accrued in 1931. It was not shown on what date the petition for certiorari was filed, what fees and expenses, if any, were incurred in opposing it, and if fees and expenses were incurred, whether they accrued in 1931 or 1932.

Furthermore, the record discloses that the last payment of a fee to the attorneys in the Hackfeld litigation prior to 1932 was on March 23, 1926, when $50,000 was paid Sutro. (R. 272.) An $85,000 fee was paid to him on July 28, 1932, but since no fee had been paid since 1926, since fees had undoubtedly accrued in the interval in defending the appeal which, as shown, terminated in 1931, and since the record does not show that the attorneys performed any services in 1932, the inference is required, for lack of proof to the contrary by the taxpayer having the burden of proof, that the fee paid in 1932 was incurred for services performed prior thereto. In this connection, it is noted that there is no evidence of record that the contract with the attorneys made the amount of their fees or the payment thereof contingent

upon the final outcome or upon the final termination of the litigation.

It is clear that the taxpayer failed to carry its burden of showing that the $87,992.50 of expenses accrued in 1932 and that the District Court erred under Section 43 of the Code in allowing a deduction in 1932 for that amount to the taxpayer.

II

The District Court Correctly Disallowed a Deduction in 1932 of $396,812.50

During the years 1924-1926 $396,812.50 of the total expenses of $455,682.27 paid in those years in defending the Hackfeld suit was determined to be the share of the stockholders of taxpayer who were defendants in the suit and who had agreed among themselves to bear their share of the expenses *pro rata* if they were named defendants. The stockholders actually contributed the amount of $396,812.50 to the expenses from 1924 through January, 1926. After certiorari was denied in April, 1932, the taxpayer repaid the $396,812.50 to the stockholders without legal obligation or liability to do so, as the District Court found. It correctly denied deduction of the $396,812.50 in 1932 as an ordinary and necessary business expense under Section 23 (a) of the Revenue Act of 1932.

The taxpayer's contention (Br. 38-39) that the District Court erred in not allowing deduction of the amount seems to rest on two theories: First, that upon the successful termination of the litigation in 1932 there arose an obligation on taxpayer's part to reimburse its stockholders for the expenses previously paid by them since the stockholders were found not to have been guilty of the acts charged against them in the suit; and second, that until the conclusion of the litigation it was impossible to determine whether taxpayer

or the stockholders were liable to pay the expenses, and the expenses of $396,812.50 therefore accrued as a liability of the taxpayer only after denial of the petition for certiorari in 1932. There is no merit to either argument.

Section 23 (a) of the Revenue Act of 1932 permits deduction of only the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any business. The amount of $396,812.50 of the litigation expenses was not incurred in carrying on the taxpayer's business and it was not an ordinary and necessary expense of the taxpayer's business so that it does not meet the requirements for deduction set out in Section 23 (a). Further, this part of the expenses did not accrue within 1932 so as to be deductible in 1932, even if, contrary to the fact, it were assumed *arguendo* that the expenses represented ordinary and necessary business expenses of the taxpayer's business which may be deducted in the proper year.

A. *The amount was not paid or incurred in carrying on the taxpayer's business*

At the outset it is again pointed out that the parties themselves determined that $396,812.50 of the total litigation expenses in the earlier years represented the amount allocable to the defense of the stockholders against the claims for their stock in taxpayer and for damages and the charges asserted against them in the suit. (R. 78-79.) Similarly, the remainder of the total expenses in the earlier years was allocated by the parties as applicable to the defense of taxpayer from the charges against it, the damages claimed from it, and the protection of its property. We do not understand that taxpayer contends now that that apportionment of the expenses was incorrect or unfair. Rather its contention is that, when the termination of the

litigation established the innocence of the stockholders as to the charges against them, taxpayer became obligated to reimburse the stockholders for the expenses paid by them in defending the charges against them, or alternatively that the expenses incurred in defending the stockholder-incorporators accrued at that time as expenses of the taxpayer.

Both contentions fail, for considered in either aspect the portion of the expenses paid or incurred in the defense of charges and claims against the stockholder-incorporators was in no sense paid or incurred in carrying on the taxpayer's business. Its business was the sugar agency and factor business and this business could not conceivably include the original payment of, or the reimbursement of the stockholder-incorporators for, expenses incurred in defending the stockholder-incorporators against charges of fraud and conspiracy alleged to have been committed by them *before the taxpayer was organized and before it engaged in any business,* and also in *protecting the stockholders' investment in taxpayer's stock.* Such expenses, as distinguished from the part of the expenses incurred to defend the taxpayer from the charges and claims against it, were the personal expenses of the stockholders and were wholly unrelated to the taxpayer's business. They neither were "directly connected with", nor "proximately resulted from", the taxpayer's business, and thus they do not qualify as a deductible business expense of the taxpayer. See *Kornhauser* v. *United States,* 276 U.S. 145, 153.

This conclusion is required by the decided cases. In *Hales-Mullaly, Inc.* v. *Commissioner,* 131 F. 2d 509 (C.A. 10th), as in the case at bar, the taxpayer corporation was joined with its incorporators as defendants in a suit for damages based on the alleged fraud and conspiracy of the incorporators in forming the tax-

payer.[4] The court held that the taxpayer corporation could not deduct the litigation expenses incurred in connection with the suit on the ground that the expenses were not ordinary expenses incurred in carrying on a business. The court said (p. 512):

> Moreover, since the fraud was committed by the individuals prior to the organization of the taxpayer, and prior to the time it first engaged in business, the liability or obligation asserted in the suit was not incurred in carrying on the business, within the meaning of the statute. * * *

See also *Blackwell Oil & Gas Co.* v. *Commissioner,* 60 F. 2d 257 (C.A. 10th), and *Knight-Campbell Music Co.* v. *Commissioner,* 155 F. 2d 837 (C.A. 10th). Cf. *White* v. *Commissioner,* 61 F. 2d 726 (C.A. 9th); *A. Giurlani & Bro.* v. *Commissioner,* 119 F. 2d 852, 856-857 (C.A. 9th); *Pantages Theatre Co.* v. *Welch,* 71 F. 2d 68, 69 (C.A. 9th); *Robinson* v. *Commissioner,* 53 F. 2d 810, 811 (C.A. 8th).

Compare also *Interstate Transit Lines* v. *Commissioner,* 319 U.S. 590, and *South American Gold & Platinum Co.* v. *Commissioner,* 8 T.C. 1297, affirmed

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[4] In the *Hales-Mullaly* case, as the court pointed out (p. 512), the suit was bottomed on fraud committed by the individuals antecedent to the existence of the taxpayer and the taxpayer's liability, if any, arose solely from its receiving and retaining the benefits of the fraud of the individuals who organized it. In the case at bar, however, damages were also claimed against the corporate taxpayer as a result of its mismanagement, after its organization and while engaged in business, of the business and assets acquired from Hackfeld. Thus, unlike the *Hales-Mullaly* case, in this case the total expenses of the litigation were apportioned between the stockholder-incorporators and the taxpayer. As already indicated, no contention is made that the expenses incurred in defending against the charges and claims made against the taxpayer are not ordinary business expenses of the taxpayer. The issue under this point relates solely to the expenses incurred in defending the stockholder-incorporators from the charges and claims made against them and this issue is parallel to that decided in the *Hales-Mullaly* case.

per curiam, 168 F. 2d 71 (C.A. 2d), in which a parent corporation was not permitted to deduct amounts paid by the parent representing, respectively, operating deficits and legal expenses of a wholly-owned subsidiary corporation. Clearly, if the payment of a subsidiary's deficit or expense cannot be deemed to be a business expense of the parent, even where the wholly-owned subsidiary incurred it in a business operated exclusively for the benefit of the parent, it follows *a fortiori* that the expenses of protecting the property of the taxpayer's stockholders and of defending them against charges of fraud and conspiracy cannot be considered expenses of the taxpayer's business.

B. *The expenses were not ordinary and necessary*

Not only were the expenses incurred in defending the stockholder-incorporators not incurred in carrying on the taxpayer's business, but the expenses were not ordinary and necessary expenses of its business, so as to permit a deduction under Section 23 (a). The District Court so held.[5]

It may be assumed that in 1932 taxpayer deemed it a moral obligation and thus "necessary" that it bear the litigation expenses incurred in defending its stockholders, but that is not sufficient under the statute. The expense must also be "ordinary". *Welch* v. *Helvering,* 290 U. S. 111; *Deputy* v. *du Pont,* 308 U. S. 488.

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[5] Taxpayer's statement (Br. 35) that the District Court held that all of the litigation expenses are ordinary and necessary business expenses is not understood. The District Court specifically concluded (R. 101):

> The sum of $396,812.50 of the Hackfeld litigation expenses which plaintiff refunded or repaid in the year 1932 to those persons and corporations who were co-defendants with plaintiff in said litigation *were not ordinary and necessary expenses* paid or incurred during the taxable year 1932 by plaintiff *in carrying on its business.* * * * (Italics supplied.)

The test to be applied in determining whether an expenditure is "ordinary" within the meaning of Section 23 (a) was made clear by the Supreme Court in *Deputy* v. *du Pont, supra,* in the following language (pp. 495-496):

> Ordinary has the connotation of normal, usual, or customary. To be sure, an expense may be ordinary though it happen but once in the taxpayer's lifetime. Cf. *Kornhauser* v. *United States, supra.* Yet the transaction which gives rise to it must be of common or frequent occurrence in the type of business involved. *Welch* v. *Helvering, supra,* 114. Hence, the fact that a particular expense would be an ordinary or common one in the course of one business and so deductible under § 23 (a) does not necessarily make it such in connection with another business. Thus, it has been held that one who was an active trader in securities might take as deductions carrying charges on short sales since selling short was common in that business. But the carrying charges on respondent's short sale in this case cannot be accorded the same privilege under § 23 (a). The record does not show that respondent was in the business of trading in securities. Nor does it show that a stockholder engaged in conserving and enhancing his estate ordinarily makes short sales or similarly assists his corporation in financing stock purchase plans for the benefit of its executives. As stated in *Welch* v. *Helvering, supra,* pp. 113-114: ". . . What is ordinary, though there must always be a strain of constancy within it, is none the less a variable affected by time and place and circumstance." One of the extremely relevant circumstances is the nature and scope of the particular business out of which the expense in question accrued. The fact that an obligation to pay has arisen is not sufficient. *It is the kind of transaction out of which the obligation arose and its normalcy in the particular business which are crucial and controlling.* (Italics supplied.)

Applying those principles to the facts here, it is obvious that the payment of the expenses of defending the stockholder-incorporators and their property from damages asserted as a result of their acts is not a usual or normal expense of carrying on a sugar agency and factoring business, or indeed of any commercial business. It was so decided in *Hales-Mullaly, Inc.* v. *Commissioner,* 131 F. 2d 509 (C. A. 10th). Indeed, the law is well settled that a taxpayer may not deduct as an ordinary and necessary business expense the payment of the liabilities of others.[6] *Welch* v. *Helvering,* 290 U. S. 111; *A. Giurlani & Bro.* v. *Commissioner,* 119 F. 2d 852 (C. A. 9th); *White* v. *Commissioner,* 61 F. 2d 726 (C. A. 9th); *Pantages Theatre Co.* v. *Welch,* 71 F. 2d 68 (C. A. 9th); *Blackwell Oil & Gas Co.* v. *Commissioner,* 60 F. 2d 257 (C. A. 10th); *Robinson* v. *Commissioner,* 53 F. 2d 810, 811 (C. A. 8th); *One Hundred Five West Fifty-Fifth St.* v. *Commissioner,* 42 F. 2d 849, 852 (C. A. 2d).

Moreover, even though taxpayer may have felt morally obliged to bear the portion of the expenses incurred in defending the stockholders, in addition to the part of the expenses incurred in defending itself, there was no legal obligation to do so. Taxpayer's argument (Br. 41-42, 48-49) that a corporation is liable for the defense of legal proceedings brought against its officers, agents, or members of its committees if the corporation has an interest in the litigation is not applicable to the facts of this case, since the codefendants in the Hackfeld litigation were not sued as officers, employees, or agents of the taxpayer. They were sued as the persons who organized the taxpayer for acts done prior to and in taxpayer's organization. A cor-

[6] The liabilities which the taxpayer thus discharged by its reimbursement were the liabilities of others. Cf. *Matson Navigation Co.* v. *Commissioner,* 24 B.T.A. 14.

of the argument only, it will be assumed, although we have conclusively demonstrated otherwise, that the expenses were ordinary and necessary expenses of taxpayer's business and that they are properly deductible by taxpayer in the year in which they accrued.

The record shows that the \$396,812.50 of the Hackfeld litigation expenses here in issue were collected by taxpayer from its codefendants and were paid at different periods from 1924 to 1926. (R. 198-200.) There is nothing in the record to show that the expenses had not been incurred and had not accrued at the time they were paid. Indeed, as was suggested under Point I, above, it is probably impossible to establish that an expense which has been paid accrues only at a later date. *Chestnut Securities Co.* v. *United States,* 62 F. Supp. 574 (C. Cls.).

Although the expenses were actually paid by the codefendants in 1924-1926, there is no reason, if the expenses were expenses for which taxpayer was legally or equitably liable as it contends, why taxpayer's liability to reimburse the stockholders did not accrue at that time. To be sure, taxpayer insists that its liability existed only if the codefendants were not guilty of the charges against them and this was not finally determined until 1932, but it cites no authority which supports a view that liability existed only if the incorporators were not held liable for fraud. *Blackwell Oil & Gas Co.* v. *Commissioner,* 60 F. 2d 257 (C. A. 10th) (cited Br. 40-41), is authority for the view that a corporation may not deduct as an ordinary business expense the expenses of defending its directors, not its incorporators, from a suit charging conspiracy, since the corporation was not legally responsible for defending a personal suit against them based on their unauthorized acts. But as pointed out, the stockholder-incorporators were not directors, agents, or employees of the taxpayer,

which had not been organized at the time the acts complained of were performed, so that the question of whether they were acting within the scope of the authority given them by taxpayer does not arise here. No authority cited by taxpayer touches on whether a corporation is liable for the acts of its incorporators. Furthermore, taxpayer accepted without question the benefits of their acts done prior to its incorporation, so that it is hardly in a position to contend that it was liable for the expenses of their defense only if they were not guilty of the fraud and conspiracy charged. If taxpayer was liable at all for their share of the expenses as taxpayer insists that it was if judgment was rendered in their favor in the Hackfeld litigation, then it is submitted that taxpayer was liable regardless of the outcome of the litigation. The liability was then incurred and accrued in 1924-1926, and the deduction, if otherwise properly allowable, cannot be taken in 1932.

For all of the foregoing reasons, the District Court's judgment denying the deduction of $396,812.50 in 1932 was correct, and should be affirmed.

III

The District Court Did Not Err in Denying the Taxpayer a Deduction in 1932 for the $50,000 Payment in 1931 Into the Fund for the Henry Waterhouse Trust Company

A. *The payment of $50,000 did not create a valid debt*

It is elementary that the allowance of a deduction for a bad debt presupposes the existence of a valid debt arising out of a debtor-creditor relationship. *Harmount* v. *Commissioner,* 58 F. 2d 118 (C.A. 6th); *Milton Bradley Co.* v. *United States,* 146 F. 2d 541, 542 (C.A. 1st); *Estate of Van Anda* v. *Commissioner,* 12 T.C. 1158, 1162. The giving of a note or other evidence of indebtedness which may be legally enforcible is not

in itself conclusive of the existence of a bona fide debt. *Montgomery* v. *United States,* 23 F. Supp. 130 (C. Cls.), certiorari denied, 307 U.S. 632; *Estate of Van Anda* v. *Commissioner, supra; Wolff* v. *Commissioner,* 26 B.T.A. 622; *Griffiths* v. *Commissioner,* 25 B.T.A. 1292; *Hayes* v. *Commissioner,* 17 B.T.A. 86.

A conditional obligation does not give rise to a debt. *Shiman* v. *Commissioner,* 60 F. 2d 65, 66 (C.A. 2d); *Milton Bradley Co.* v. *United States, supra,* p. 542; *S. Naitove & Co.* v. *Commissioner,* 32 F. 2d 949 (C.A. D.C.); *Wolff* v. *Commissioner, supra,* p. 626. This principle was explained by the First Circuit in the *Milton Bradley Co.* case as follows (p. 542):

> One of the underlying conditions of validity is an unconditional obligation of the debtor to pay the creditor. "The debts which the statute permits to be charged off when ascertained to be worthless are debts where there is an obligation of the debtor to pay and a right of the creditor to receive and enforce payment." *J. S. Cullinan* v. *Commissioner of Internal Revenue,* 19 B.T.A. 930. "The sine qua non of a debt is the obligation to pay. * * * And this means not a contingent obligation, * * *." *Wolff* v. *Commissioner of Internal Revenue,* 26 B.T.A. 622, 626, and cases cited. The liability to pay in the future, contingent upon something which may or may not occur, is not indebtedness, and the taxpayer may not treat as worthless debts amounts which are at a particular time merely contingent liabilities. *Eckert* v. *Burnet,* 1931, 283 U.S. 140, 51 S. Ct. 373, 75 L. Ed. 911; *S. Naitove & Co.* v. *Commissioner of Internal Revenue,* 1929, 59 App. D.C. 53, 32 F. 2d 949; *Wolff* v. *Commissioner, supra.* Where the liability to pay is not absolute, the existence of a deductible debt has not been accepted. *Howell* v. *Commissioner of Internal Revenue,* 8 Cir., 1934, 69 F. 2d 447, certiorari denied *Howell* v. *Helvering,* 1934, 292 U.S. 654, 54 S. Ct. 864, 78 L. Ed. 1503; *American Cigar Co.* v. *Commissioner of*

> *Internal Revenue,* 2 Cir., 1933, 66 F. 2d 425, certiorari denied 1933, 290 U.S. 699, 54 S. Ct. 209, 78 L. Ed. 601; *In re Park's Estate,* 2 Cir., 1932, 58 F. 2d 965, certiorari denied, 1932, *Park's Estate* v. *Commissioner of Internal Revenue,* 287 U.S. 645, 53 S. Ct. 91, 77 L. Ed. 558. * * *

The District Court in this case concluded (R. 102) that the payment of $50,000 to Waterhouse in 1931 was just a contribution by taxpayer, that the note given was contingent as to payment and subject to such conditions as to render it without negotiable value at any time, and that it therefore cannot be dealt with as a debt. If the note was contingent as to payment, the District Court was manifestly correct under the cited authorities[7] in concluding that it was not a "debt" which can be the basis of a deduction for a bad debt under Section 23 (j) of the Revenue Act of 1932 (Appendix, *infra*).

It is plain that the finding that the note was contingent as to payment could not be successfully challenged, and the taxpayer does not attempt to do so. The note given to taxpayer by Waterhouse had a proviso which read (R. 90, 410)—

> * * * payment of principal and interest to be made only when, if and to the extent that there

[7] The cases of *Clay Drilling Co.* v. *Commissioner,* 6 T.C. 324, and *Western Woodwork & Lumber Co.* v. *Commissioner,* decided May 9, 1947 (1947 P-H T.C. Memorandum Decisions, par. 47,124), are cited by taxpayer (Br. 61-65) as authority to the contrary. The issue in the *Clay* case was whether a valid indebtedness had been cancelled and forgiven in an earlier year as a result of an agreement under which the debt became payable only in the manner agreed upon. The Tax Court held that it was not cancelled. While the *Western* case did apparently rule that a note represented a debt despite the contingent nature of its payment, no deduction for a bad debt was allowed in 1943 because the note became worthless in an earlier year. To the extent that the unreviewed memorandum opinion of the Tax Court in the *Western* case is contrary to the authorities cited above, it is against the clear weight of authority and is, we submit, incorrect.

shall be funds available therefor as set forth in letter of this date from the payor to the payee.

The conditions stated in the letter (R. 85-90, 402-407) were that payment was to be made only after expenses of the liquidation, $1,000 per month to Bishop for supervision, interest, indebtedness, and other liabilities were paid in that order, and after Bishop was reimbursed for the amounts contributed by it, if any, required (in excess of the $1,035,000) to liquidate Waterhouse's liabilities. The fact that the note was not absolute as to payment is alone enough to require the finding that no debt sufficient to support a deduction under Section 23 (j) was created.

Moreover, it has been repeatedly held that advances voluntarily made without expectation of repayment do not create a "debt" which can provide the basis for a bad debt deduction. *Spring City Co.* v. *Commissioner,* 292 U.S. 182, 189; *Porter* v. *United States,* 27 F. 2d 882 (C.A. 9th); *American Cigar Co.* v. *Commissioner,* 66 F. 2d 425 (C.A. 2d), certiorari denied, 290 U.S. 699; *W. F. Young, Inc.* v. *Commissioner,* 120 F. 2d 159 (C.A. 1st); *Busch* v. *Commissioner,* 50 F. 2d 800 (C.A. 5th); *Menihan* v. *Commissioner,* 79 F. 2d 304 (C.A. 2d); *Hayes* v. *Commissioner,* 17 B.T.A. 86, 87; *Wolff* v. *Commissioner,* 26 B.T.A. 622; see particularly, *Davis* v. *Commissioner,* decided November 3, 1937 (1937 P-H B.T.A. Memorandum Decisions, par. 37,312); *McLeod* v. *Commissioner,* 19 B.T.A. 134, 139.

That principle is applicable here in support of the conclusion that no real debt was created. The District Court found that the payment of $50,000 was merely a contribution without expectation of repayment, other than preventing Waterhouse from closing due to its insolvent condition and protecting the commercial community and Waterhouse's clients who could ill afford to lose. (R. 60-61, 96, 102-103.) These

findings are clearly correct when all the circumstances existing at the time that taxpayer was solicited to contribute to the fund and agreed to do so are taken into account. Although taxpayer argues (Br. 57-61) that the findings in this respect are erroneous, the testimony of the witnesses relied on (Br. 59-60) at most indicates that some of those who contributed expected and hoped that some part of the contributions would not be needed and would be returned. Facts with respect to Waterhouse's financial position in 1931 to support such a hope were not shown; the Waterhouse balance sheet and the audit report prepared at the time based on book figures (R. 91-95) were not shown to represent the actual value of the assets. And it is obvious from the whole record that the contributions were made for the principal purpose or motive of preventing Waterhouse's failure, irrespective of whether the contributions might be returned in whole or in part. Indeed, taxpayer apparently concedes (Br. 66) that the motive for "advancing" the money was the protection of the commercial community as the District Court found, but argues that the reason for making the advance and its wisdom from the standpoint of being repaid are not pertinent. Such matters of course are material on the question of whether the payment was voluntarily made without expectation of repayment, and the District Court's finding here on that question is amply supported and is correct.

There was no evidence that taxpayer would have lost anything through Waterhouse's failure if it had not contributed to the fund, as the District Court found (R. 96), and the contribution was not therefore required to protect an existing indebtedness, investment or claim against Waterhouse. This is additional confirmation that the contribution was voluntarily made.

It is submitted that the District Court's finding that the taxpayer's payment of $50,000 into the Waterhouse fund was not a debt was correct and should be affirmed.

B. *The debt was not ascertained to be worthless in 1932*

The District Court concluded that no part of the $50,000 was deductible as a bad debt ascertained to be worthless and charged off within the taxable year 1932 within the terms of Section 23 (j) of the Revenue Act of 1932. (R. 103.)

Even if it is assumed, *arguendo* only, that the payment of the $50,000 into the Waterhouse fund created a valid debt, we believe the evidence clearly supports the District Court's conclusions stated above. The record discloses that a reserve of $680,803.15 was set up on the books of Waterhouse as at February 14, 1931, after the reorganization against which all liquidating and operating losses were to be charged. (R. 94-95.) The District Court made a finding of fact (to which the taxpayer does not express any disagreement) which reads as follows (R. 95):

> At December 31, 1931, Henry Waterhouse Trust Company had sustained on liquidation actual losses amounting to $324,913.77, and at December 31, 1932, it had sustained on liquidation cumulative actual losses totalling $410,345.80, so that at the end of 1932 there was still a balance of $190,457.35 remaining in the Reserve for Losses, against which future losses must be paid before there would be any impairment for the repayment of the $400,000.00 contributions to the special noteholders.

Nevertheless, the taxpayer asserts (Br. 53) that by the end of 1932 it became apparent to it that, by reason of the further reduction in the value of the assets out of which the notes were to be paid, the note held by it

was valueless and was charged off as a loss on its books. The taxpayer relies on a letter dated July 18, 1932, addressed to the noteholders in which Waterhouse informed the taxpayer and other special noteholders that an exhaustive reappraisal disclosed that its liabilities, other than those to the underwriters and stockholders, exceeded the value of its assets by a very considerable amount and expressed the opinion that the $50,000 note had no value whatever. (R. 413-414.)

Mere reliance upon the opinion stated in that letter as to the alleged valuelessness of Waterhouse's special notes, without more, is not a sufficient ascertainment of worthlessness as to satisfy the statute. It is a fundamental rule that mere statements of opinion as to worthlessness are insufficient to satisfy the statutory requirements, and that the facts with respect to the alleged valuelessness of the notes must be presented to the court so that it may form an independent judgment as to the ascertainment of worthlessness. *Rosenthal v. Helvering,* 124 F. 2d 474 (C. A. 2d); *Georgia Engineering Co.* v. *Commissioner,* 21 B. T. A. 532, 547-548; *Gano* v. *Commissioner,* 19 B. T. A. 518. This Court in *American Trust Co.* v. *Commissioner,* 31 F. 2d 47, held that an investigation which shows only that the debtor is in an unsatisfactory financial condition and that the collection of the debt is doubtful, is not a sufficient ascertainment of worthlessness.

In addition to the letter from Waterhouse mentioned above, the taxpayer refers (Br. 67-71) to the testimony of its witnesses Lowrey and Castle, and Linden, a witness for Alexander & Baldwin, Limited, as support for the assertion in its brief that it ascertained the note to be worthless in 1932 and charged it off. But we submit that their testimony merely indicates that the taxpayer relied upon the opinions of others, and as shown, without investigation and proof of the facts on which the

opinions were based, that is not a sufficient showing of worthlessness.

Reverting to the reappraisal mentioned in that letter which Mr. Castle testified had been made, there is no evidence which shows whether the appraisal was reduced to writing, when it was made, who made it and their qualifications for such a task, and what method they adopted and why. There is no evidence of the details of that appraisal; it is not disclosed what values were used, whether cost or market, and if the latter, as of what date and how such values were determined. Furthermore, there is no evidence which identifies or describes the property appraised, so that it is not disclosed whether the property was physical or intangible property, whether it was subject to depreciation, and if so, when it was acquired and the depreciation sustained to the date of the appraisal. If the property included securities, there is no information as to whether they were listed on any exchanges, the size of the blocks of securities, whether the market therefor was active or inactive. In short, the basis on which the reappraisal was made was not shown and the trial court was therefore not furnished with the facts necessary to enable it to determine that taxpayer's alleged ascertainment of worthlessness of the note was based on facts warranting that conclusion. Indeed, it would seem that if the facts in 1932 justified an ascertainment of worthlessness, the facts would have justified the same conclusion in 1931, since Waterhouse was then apparently insolvent (R. 61) and required substantial assistance to pay off its liabilities. It was not shown that the reappraisal was made in 1932 rather than 1931, but in any case a reappraisal in 1931, would doubtless have disclosed the same situation as existed in 1932.

Despite the assertion to the contrary made in the taxpayer's brief (p. 53), we submit that the evidence of

record indicates clearly that the taxpayer could not have been convinced that the note had become valueless in 1932, assuming *arguendo* of course that taxpayer ever believed that the note had value. As the District Court found, at the end of 1932 the reserve for liquidating losses had not been exhausted. (R. 95.) Also the letter from Waterhouse in 1932 contained the following (R. 414):

> Despite the worthlessness of the note it remains an apparent liability of this Company and operates as a hindrance to its speedy liquidation, especially as so long as it remains on our books the Advisory Committee will have to be continued. *Hence we suggest that you concede the worthlessness of the note by formally authorizing this Company to consider that it is no longer an obligation.* (Italics supplied.)

It was stipulated that the advisory committee was not abrogated but continued to function as usual during the balance of 1932 and the year 1933. (R. 390-391.) Lowrey testified that the taxpayer did not make a formal reply to the Waterhouse letter. (R. 474-475.) Not only did the taxpayer refuse to comply with the request of Waterhouse that it formally concede that the note was worthless and surrender it to Waterhouse, but the other noteholders likewise refused to do so. (R. 517.) Yet, for federal income tax purposes, the taxpayer seeks relief here on the ground that it ascertained the note to be worthless in 1932, having refused, however, to make such a concession to Waterhouse. The fact that it charged off the note as a loss on its books is insufficient. *Spring City Co.* v. *Commissioner,* 292 U. S. 182, 189.

In view of the foregoing, we believe the District Court's conclusions are fully supported by the evidence and should be sustained.

C. *Neither is the $50,000 paid to Waterhouse deductible as a loss sustained or as an ordinary and necessary business expense of the taxpayer in 1932*

In the alternative, the taxpayer maintains (Br. 69-75) that the District Court should have allowed it to deduct the $50,000 as a business loss or as an ordinary and necessary business expense in the year 1932.

Section 23 (f) of the Revenue Act of 1932 (Appendix, *infra*) permits corporations to deduct losses sustained during the taxable year if not compensated for by insurance or otherwise. No loss was sustained by taxpayer in 1932 which may be deducted under this section, as the District Court held. (R. 103.)

As previously pointed out, the District Court found that the payment was voluntary, and was a contribution made without expectation of repayment. (R. 60-61, 64-65, 96, 102-103.) The loss, *if any,* from the contribution was therefore sustained when the payment was made, in 1931, rather than in 1932, although we believe that a contribution in the circumstances here could not form the basis for a deduction of a loss at any time. Cf. *Commissioner* v. *Gilt Edge Textile Corp.,* 173 F. 2d 810 (C. A. 3d); *Uhl Estate Co.* v. *Commissioner,* 116 F. 2d 403 (C. A. 9th).

Furthermore, in view of the District Court's finding of fact that at the end of 1932 there was still a balance of $190,457.35 remaining in the reserve for losses against which future losses must be charged before there would be any impairment for the repayment of the $400,000 contributions to the special noteholders (R. 95), there can be no doubt that the taxpayer did not sustain any loss during the taxable year 1932 in respect to its contribution to that fund. See *McLeod* v. *Commissioner,* 19 B. T. A. 134, 139, appeal dismissed

on September 25, 1931, by Court of Appeals for the First Circuit without written opinion. No identifiable event occurred in 1932 which fixed a loss deductible from gross income. *United States* v. *White Dental Co.*, 274 U. S. 398. Cf. *A. Giurlani & Bro.* v. *Commissioner*, 119 F. 2d 852, 857 (C. A. 9th).

Since we have fully discussed under Point II of this brief what are deemed to be ordinary and necessary expenses of carrying on business, we think it will suffice here to say that there is no evidence to support a conclusion that the expenditure of the $50,000 was an ordinary and necessary expense of carrying on the taxpayer's business during the taxable year 1932. It was not usual and customary in the sugar agency and factor business to make a contribution of this sort. On the contrary the contribution was extraordinary in nature. Moreover, the record shows that the money was paid into the fund in 1931 (R. 60-61, 96, 398, 464), and that taxpayer's liability to contribute the amount was fixed in 1931 by its unconditional promise to pay (R. 84). As the taxpayer's books are kept on the accrual basis of accounting (R. 394), it could not accrue this expenditure as an expense of doing business in the year 1932 when its liability became fixed and thus accrued in 1931 and the payment was actually made in that year. Cf. *Chestnut Securities Co.* v. *United States*, 62 F. Supp. 574 (C. Cls.).

In *Robert Gaylord, Inc.* v. *Commissioner*, 41 B. T. A. 1119, and *Moloney Electric Co.* v. *Commissioner*, 42 B. T. A. 78, relied on by taxpayer here (Br. 71-74), the Tax Court reached a conclusion on the facts there that contributions similar to those here could be deducted as an ordinary and necessary business expense in 1936. It does not appear that the corporations in those cases were on the accrual basis of accounting and the con-

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Section 23 (f) of the Revenue Act of 1932 (Appendix, *infra*) permits corporations to deduct losses sustained during the taxable year if not compensated for by insurance or otherwise. No loss was sustained by taxpayer in 1932 which may be deducted under this section, as the District Court held. (R. 103.)

As previously pointed out, the District Court found that the payment was voluntary, and was a contribution made without expectation of repayment. (R. 60-61, 64-65, 96, 102-103.) The loss, *if any,* from the contribution was therefore sustained when the payment was made, in 1931, rather than in 1932, although we believe that a contribution in the circumstances here could not form the basis for a deduction of a loss at any time. Cf. *Commissioner* v. *Gilt Edge Textile Corp.,* 173 F. 2d 810 (C. A. 3d); *Uhl Estate Co.* v. *Commissioner,* 116 F. 2d 403 (C. A. 9th).

Furthermore, in view of the District Court's finding of fact that at the end of 1932 there was still a balance of $190,457.35 remaining in the reserve for losses against which future losses must be charged before there would be any impairment for the repayment of the $400,000 contributions to the special noteholders (R. 95), there can be no doubt that the taxpayer did not sustain any loss during the taxable year 1932 in respect to its contribution to that fund. See *McLeod* v. *Commissioner,* 19 B. T. A. 134, 139, appeal dismissed

on September 25, 1931, by Court of Appeals for the First Circuit without written opinion. No identifiable event occurred in 1932 which fixed a loss deductible from gross income. *United States* v. *White Dental Co.*, 274 U. S. 398. Cf. *A. Giurlani & Bro.* v. *Commissioner*, 119 F. 2d 852, 857 (C. A. 9th).

Since we have fully discussed under Point II of this brief what are deemed to be ordinary and necessary expenses of carrying on business, we think it will suffice here to say that there is no evidence to support a conclusion that the expenditure of the $50,000 was an ordinary and necessary expense of carrying on the taxpayer's business during the taxable year 1932. It was not usual and customary in the sugar agency and factor business to make a contribution of this sort. On the contrary the contribution was extraordinary in nature. Moreover, the record shows that the money was paid into the fund in 1931 (R. 60-61, 96, 398, 464), and that taxpayer's liability to contribute the amount was fixed in 1931 by its unconditional promise to pay (R. 84). As the taxpayer's books are kept on the accrual basis of accounting (R. 394), it could not accrue this expenditure as an expense of doing business in the year 1932 when its liability became fixed and thus accrued in 1931 and the payment was actually made in that year. Cf. *Chestnut Securities Co.* v. *United States*, 62 F. Supp. 574 (C. Cls.).

In *Robert Gaylord, Inc.* v. *Commissioner*, 41 B. T. A. 1119, and *Moloney Electric Co.* v. *Commissioner*, 42 B. T. A. 78, relied on by taxpayer here (Br. 71-74), the Tax Court reached a conclusion on the facts there that contributions similar to those here could be deducted as an ordinary and necessary business expense in 1936. It does not appear that the corporations in those cases were on the accrual basis of accounting and the con-

tributions there were actually paid in 1936, the year in which allowed, although they had been deposited in a bank in 1931 where they were held, drawing interest, until needed by the bank being liquidated. Thus, those decisions, whatever view is taken as to their validity, are not authority for allowing the deduction to this taxpayer in 1932, where the liability for the contribution accrued and the contribution was paid in 1931.

The taxpayer in its brief (p. 75) in effect asks this Court to consider the facts found by the Board of Tax Appeals (now the Tax Court) in *Bishop Trust Co.* v. *Commissioner,* 36 B. T. A. 1173, and *Bishop Trust Co.* v. *Commissioner,* 47 B. T. A. 737, as facts for purposes of this case. While we think that the Board found no facts which assist the taxpayer's position in this case, nevertheless it is submitted that the Court may not look to the findings in those cases involving a different taxpayer to supplement the record in this case. The taxpayer's burden of proof required it to prove in this case whatever facts were necessary to support its claims for refund of the tax paid.

In view of the foregoing, we submit that the District Court's conclusions were correct and should not be disturbed.

CONCLUSION

The decision of the court below as to the deductibility of $171,795.26 of the Hackfeld litigation expense on the undisputed facts of the case is erroneous and contrary to law and the authorities, and therefore should be reversed.

The decision of the court below as to the other issues involved should be affirmed.

Respectfully submitted,

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April, 1950.

APPENDIX

Revenue Act of 1932, c. 209, 47 Stat. 169:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) *Expenses.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, * * *

* * * * *

(f) *Losses by Corporations.*—Subject to the limitations provided in subsection (r) of this section in the case of a corporation, losses sustained during the taxable year and not compensated for by insurance or otherwise.

* * * * *

(j) *Bad Debts.*—Debts ascertained to be worthless and charged off within the taxable year * * *

* * * * *

SEC. 41. GENERAL RULE

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayers; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. * * *

SEC. 43. PERIOD FOR WHICH DEDUCTIONS AND CREDITS TAKEN.

The deductions and credits provided for in this title shall be taken for the taxable year in which "paid or accrued" or "paid or incurred", dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to

clearly reflect the income the deductions or credits should be taken as of a different period.

Treasury Regulations 77, promulgated under the Revenue Act of 1932:

ART. 121. *Business expenses.*—Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business, except the classes of items which are deductible under the provisions of articles 141-272. * * *

ART. 171. *Losses.*—* * *

Subject to the limitations on losses from sales or exchanges of stocks and bonds provided in section 23 (r) and article 272, losses sustained by corporations during the taxable year and not compensated for by insurance or otherwise are also fully deductible.

Losses must usually be evidenced by closed and completed transactions. * * *

* * * * *

ART. 191. *Bad debts.*— * * *

Where all the surrounding and attending circumstances indicate that a debt is worthless, either wholly or in part, the amount which is worthless and charged off or written down to a nominal amount on the books of the taxpayer shall be allowed as a deduction in computing net income. There should accompany the return a statement showing the propriety of any deduction claimed for bad debts. No deduction shall be allowed for the part of a debt ascertained to be worthless and charged off prior to January 1, 1921, unless and until the debt is ascertained to be totally worthless and is finally charged off or is written down to a nominal amount, or the loss is determined in some other manner by a closed and completed transaction. Before a taxpayer may charge off and deduct a debt in part, he must ascertain and be

able to demonstrate, with a reasonable degree of certainty, the amount thereof which is uncollectible. * * *

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ART. 321. *Computation of net income.*—Net income must be computed with respect to a fixed period. Usually that period is 12 months and is known as the taxable year. Items of income and of expenditures which as gross income and deductions are elements in the computation of net income need not be in the form of cash. It is sufficient that such items, if otherwise properly included in the computation, can be valued in terms of money. The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. (See articles 331-333.) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it.

ART. 341. *"Paid or incurred" and "paid or accrued."*—The terms "paid or incurred" and "paid or accrued" will be construed according to the method of accounting upon the basis of which the net income is computed by the taxpayer. (See section 48 (c).) The deductions and credits provided for in Title I must be taken for the taxable year in which "paid or accrued" or "paid or incurred," unless in order clearly to reflect the income such deductions or credits should be taken as of a different period. If a taxpayer desires to claim a deduction or a credit as of a period other than the period in which it was "paid or accrued"

or "paid or incurred," he shall attach to his return a statement setting forth his request for consideration of the case by the Commissioner together with a complete statement of the facts upon which he relies. However, in his income tax return he shall take the deduction or credit only for the taxable period in which it was actually "paid or incurred," or "paid or accrued," as the case may be. Upon the audit of the return, the Commissioner will decide whether the case is within the exception provided by the Act, and the taxpayer will be advised as to the period for which the deduction or credit is properly allowable.

ART. 342. *When charges deductible.*—Each year's return, so far as practicable, both as to gross income and deductions therefrom, should be complete in itself, and taxpayers are expected to make every reasonable effort to ascertain the facts necessary to make a correct return. The expenses, liabilities, or deficit of one year can not be used to reduce the income of a subsequent year. (But see section 117 and articles 651-655.) A taxpayer has the right to deduct all authorized allowances, and it follows that if he does not within any year deduct certain of his expenses, losses, interest, taxes, or other charges, he can not deduct them from the income of the next or any succeeding year. * * *

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